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SUBJECT: UKRAINE: THE CRIMEAN ECONOMY, PART II - RUSSIAN
INFLUENCE

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B) KYIV 2031
C) KYIV 1977
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Classified By: Acting Economic Counselor William Klein for
Reasons 1.4 (b) and (d)

¶1. (C) Summary: Russia continues to be the largest foreign investor in Crimea, although there is disagreement over whether Russian investment is mainly commercially motivated, and hence good for development, or whether the Kremlin directs it for political purposes. Crimean authorities support Russian plans for a bridge from Russia across the Kerch Strait, but Kyiv is currently blocking the project. Sevastopol, home to the Russian Black Sea Fleet, is grappling with the economic consequences of the fleet's potential departure. City officials have developed, with support from USAID, a strategic plan to promote tourism and marine industry, although Sevastopol's fractured and contentious political climate makes such planning difficult. This economic reporting trip highlighted the need to expand our USG presence in Crimea. End Summary.

¶2. (U) This is Part II of a two-part report on the Crimean economy, resulting from Econoff's trip to the region October 20-24. Part I (ref A) provided an overview of economic issues.

Russian Investment

¶3. (SBU) According to official statistics, Russia is the largest foreign investor in Crimea, with 31 percent of the total. (Note: Cyprus and the British Virgin Islands, offshore zones often used by Russian and Ukrainian businesses, account for an additional 9 percent each. End note.) Neonila Grachova, President of the Chamber of Commerce of Crimea, noted that the EU as a whole was a close second, however, and that FDI from the EU was growing steadily. Grachova added that the bulk of Russian investment in Crimea appeared to go to new construction projects, especially in the tourist sector.

¶4. (C) Oleksandr Shevchuk, Director of the Crimean branch of the National Institute for Strategic Studies, told Econoff that he believed Russian investment in Crimea was more "political" than substantive, driven by the Kremlin's desire to show the flag rather than by significant interest from Russian investors. Sergey and Larissa Shipico, stringers who cover Crimean issues for the BBC, told Econoff that Crimea had witnessed a significant increase in Russian investment beginning in 2006. Given the abrupt shift and the high-profile nature of the new investments, with officials like Moscow mayor Yuriy Luzhkov traveling to

Crimea for public events, the journalists said they believed this increase resulted from orders given by the Kremlin. Larissa Shipico added that Russian investors often established close ties to local officials through bribery and used these relationships to block other foreign companies that wanted to invest in Crimea.

Bridge to Russia Currently Going Nowhere

¶15. (C) Although the Kerch Strait, which separates the eastern tip of Crimea from Russian territory, is only three miles wide at its narrowest point, there is currently no bridge linking Crimea to Russia. Russian officials, spearheaded by Moscow mayor Yuriy Luzhkov, have for years proposed building such a bridge near the Crimean city of Kerch. Crimean officials strongly support the idea and say they believe such a bridge would help bolster Crimea as a transport hub, facilitating East-West trade, and help to bring more Russian tourists to Crimea. This project would cost roughly \$500 million but could be financed with private money by making the bridge a toll road. Crimean Prime Minister Viktor Plakida said that Ukraine's Ministry of Foreign Affairs was currently blocking progress, however, on the grounds that the border with Russia needed to be fully demarcated first. (Comment: It is also possible that Kyiv officials fear the increased ties with Russia that the bridge would bring. End Comment.)

¶16. (C) Most officials, both local and in Simferopol, told Econoff that they believed the bridge would significantly bolster development. Yet some observers, such as journalist Larissa Shipico, claim the bridge is more of a

political project meant to increase ties to Russia and lessen dependence on mainland Ukraine.

Sevastopol - Bleeding (Russia's) Red, White, and Blue

¶17. (SBU) Sevastopol, the home to Russia's Black Sea Fleet (BSF), has drawn much attention of late as Ukraine and Russia jockey over the BSF's future (ref B). Most experts agree that approximately 20,000 of Sevastopol's Ukrainian residents work directly for BSF institutions, with an unknown additional number -- around one fifth of total residents, according to some estimates -- earning a living from BSF demand for other services. (Note: Sevastopol has a population of 380,000. End note.) Liudmila Vyshnia, President of the Sevastopol Chamber of Commerce, told Econoff that the city was witnessing increased foreign investment, particularly from Russia, and estimated current Russian investment in Sevastopol at \$41 million.

Dealing with BSF Closure

¶18. (C) The departure of the BSF could have potentially disastrous economic consequences for Sevastopol, and local leaders in Sevastopol are only beginning to grapple with the issue. Working with a USAID project, city officials have drafted a strategic plan to simultaneously promote tourism and marine industries -- new ports for trade, fishing, ship repair, etc. Volodymyr Arabadzhly, City Council member and chairman of the Council's Commission on City Development, told Econoff that city leaders, himself included, were pursuing this dual strategy because they felt that tourism was too seasonal to support the Sevastopol economy on its own.

¶19. (C) Arabadzhly complained that the rental fees paid by the BSF were too low, noting that Sevastopol earned only about \$25 million a year. (Note: Russian annual payments to Kyiv for the BSF basing are \$97 million. End note.) He said that the city lost out on some \$2 billion in taxes, as the BSF received sizeable tax breaks not available to businesses. (Note: This estimate assumes that, if the BSF were to leave, private businesses would completely fill the

void. End note.) There was still available space to develop new port infrastructure, Arabadzhy said, but the BSF had the best locations and currently occupied too much territory. He complained that Russian investment, such as high-profile construction projects financed by Moscow mayor Yuriy Luzhkov, was not substantive enough to drive economic growth and appeared mostly political in nature. Vasyl Khmara, a local business consultant, argued that Sevastopol would actually be better off economically without the BSF, citing the lost tax revenues. He said that tourism, ports, and fishing all had great potential but were being squeezed out by the BSF's dominance of the city and its coastline.

Political Climate not Conducive to Development

¶10. (SBU) Sevastopol's complicated and uncertain legal status also inhibits economic development. Sevastopol and Kyiv are the only two Ukrainian cities that constitute their own administrative units. Ukraine's Constitution calls for special laws to regulate the administration of these two cities, but the law for Sevastopol, unlike for Kyiv, was never adopted. (Note: Ukraine's parliament passed versions of the Sevastopol law on several occasions, but then-President Kuchma vetoed the legislation each time. Observers see adoption of the law as unlikely in the near S;#QQ6h,Xh term, as any Ukrainian President will probably prefer the current status quo to giving Sevastopol more autonomy from Kyiv. End Note.)

¶11. (C) Political power in Sevastopol is fractured as a result, with both an Executive Administration and a City Council vying for control. The head of the Executive Administration is appointed by the Ukrainian President, wields significant powers, and is not accountable to the people. The City Council is elected by the people, has less authority, and tends to be dominated by aggressively pro-Russian, populist politicians. The current head of the Executive Administration, Sergey Kunitsin, is considered by many to be among Crimea's most influential political figures. Arabadzhy and others told Econoff that Kunitsin was actively using his position to grant state land to his inner circle and gobble up other valuable state assets. (Bio Note: As a sign of his prominence beyond Sevastopol,

Kunitsin is personally financing the construction of a new church, which will be the largest in Crimea, in Simferopol. End Note.)

Comment: Need to Expand USG Presence

¶12. (C) Both its geographical distance and autonomous political system make Crimea a difficult place to follow from Kyiv. Meant to compliment our political reporting from Crimea (ref C and previous), this report unfortunately only scratches the surface of the economic issues facing the peninsula. Although some interlocutors welcomed the opportunity to meet with an Embassy representative, Econoff found the general atmosphere to be deeply suspicious. Especially in Sevastopol, there was obvious unease about meeting with an Embassy official, and it was clear that several interlocutors, at least, had to report to someone on their meeting with Econoff. If the USG wants to engage Crimean officials more forcefully, then we will need to expand our presence there. Post's mission-wide Crimea working group (ref D) will continue to look at how to do so, including the idea for an American Presence Post in Crimea.

TAYLOR